Daiwa Bank

Lessons learned

- Risk-taking functions must be segregated from record-keeping and risk assessment functions. It's a lesson that's now been largely learned in terms of segregating traders from the back office - but it has much wider applications;
- Structural problems in risk management don't put themselves right. Daiwa had many warning signals about the way risk management was organised at the New York branch, but chose to believe that local management had learned its lesson;
- Massive fraud can continue for many years in an environment of lax controls: Iguchi made his confession not because he feared he was about to be caught, but instead when he realised that the situation might otherwise carry on indefinitely;
- Years after an event, failures in risk management remain a threat to the personal finances of senior executives if the executives can be shown to have acted inappropriately.

On July 13, 1995, Daiwa Bank's Toshihide Iguchi confessed, in a 30-page letter to the president of his bank in Japan, that he had lost around $1.1 billion while dealing in US Treasury bonds.

The executive vice president of Daiwa's New York branch had traded away the bank's money over 11 years – an extraordinarily long period for such a fraud to run – while using his position as head of the branch's securities custody department to cover up the loss by selling off securities owned by Daiwa and its customers.

The trading loss was one of the largest of its kind in history. But it was the cover-ups by Iguchi over a period of years, and then by senior managers at Daiwa between July 13 and September 18 1995, when the bank eventually reported the loss to the US Federal Reserve Board, that did the real damage. These led to criminal indictments against the bank and its officers and, eventually, to one of Japan's largest commercial banks being kicked out of the US markets.

Unlike Barings Bank, which was swallowed up by similar failures in risk management earlier in the same year, Daiwa's $200 billion of assets and $8 billion of reserves meant it was big enough to survive the hit. But punishment by US regulators and public humiliation dealt a massive blow to Daiwa's reputation. The scandal set in train a long-term change in strategy as Daiwa reigned in its international ambitions and concentrated on its core businesses in Japan and Southeast Asia.

There were also long-term personal repercussions for Daiwa's senior managers. Five years after the debacle broke, on 20 September 2000, in a decision that was immediately challenged, a Japanese court in Osaka told 11 current and former board members and top executives from Daiwa to pay the bank $775 million in damages.

The record-breaking award, which followed legal action by shareholders, was to atone for the management failure of oversight, attempted cover-ups, and the breakdown of risk management in the New York branch that led up to the debacle.

The Story

Toshihide Iguchi, a Kobe, Japan-born US citizen who majored in psychology at Southwest Missouri State University, Springfield, joined Daiwa's New York branch in 1977. There he learned how to run the small back office of the branch's securities business. Opened as an office in the 1950s, the Daiwa New York branch began dealing in US Treasury securities as part of Daiwa's services to its pension fund customers. During the 1980s the New York desk became a significant force in the US government debt market and was designated as a primary market dealer in 1986.

When Iguchi was promoted to become a trader in 1984, he did not relinquish his back-office duties. All in all, he supervised the securities custody department at the New York branch from approximately 1977 right through to 1995. This lack of segregation, a relatively common feature of small trading desks in the early 1980s but already a discredited practice by the early 1990s, led to Daiwa's downfall.

Daiwa's New York branch managed the custody of the US Treasury bonds that it bought, and those that it bought on behalf of its customers, via a sub-custody account held at Bankers Trust. Through this account, interest on the bonds was collected and dispersed, and bonds were transferred or sold according to the wishes of either customers or the bank's own managers. Daiwa and its customers kept track of what was happening in this account through transaction reports from Bankers Trust that flowed through Iguchi, in his role as head of the back office.

When Iguchi lost a few hundred thousand dollars early on in his trading activities, he was tempted into selling off bonds in the Bankers Trust sub-custody account to pay off his losses. Then, in the words of the FBI agents who investigated the case: "He concealed his unauthorised sales from the custody account ... by falsifying Bankers Trust account statements so that the statements would not indicate that the securities had been sold."

As he lost more money trying to trade his way back into the black, it became hard work keeping alive this parallel series of reports. But luckily for him, Daiwa and its internal auditors never independently confirmed the custody account statements.

Later on, while he served his sentence, Iguchi was asked by *Time* magazine whether his early actions felt like a crime. "To me, it was only a violation of internal rules," he said. "I think all traders have a tendency to fall into the same trap. You always have a way of recovering the loss. As long as that possibility is there, you either admit your loss and lose face and your job, or you wait a little – a month or two months, or however long it takes."

In Iguchi's case it took 11 years, during which time he is said to have forged some 30,000 trading slips, among other documents. When customers sold off securities that Iguchi had, in fact, already sold off on his own behalf, or when customers needed to be paid interest on long-gone securities, Iguchi settled their accounts by selling off yet more securities and changing yet more records. Eventually about $377 million of Daiwa's customers' securities and about $733 million of Daiwa's own investment securities had been sold off by Iguchi to cover his trading losses.

As Iguchi's apparent success grew – he later said that at one point his desk produced half the New York branch's nominal profits – he became something of a golden boy at Daiwa. But the losses accumulated until by the early 1990s it was difficult for Iguchi to continue to hide them, particularly after 1993 when Daiwa made some limited efforts to split up its trading and back-office functions. Yet he managed to survive for another two years before engineering his own day of reckoning.

> 'Subsequent investigation showed that risk control lapses and cover-ups were part of the culture of Daiwa's New York operation in the 1980s and 1990s'

Iguchi's survival wasn't entirely down to luck. Subsequent investigation showed that risk control lapses and cover-ups were part of the culture of Daiwa's New York operation in the 1980s and early 1990s, to a farcical degree. For example, during the 1995 investigation of the Iguchi affair, the bank was also charged with operating an unauthorised trading area for securities between 1986 and 1993.

According to the charges laid against the bank by US officials, Daiwa had gone so far as to "temporarily relocate certain traders ... and, when necessary, to disguise the trading room at the downtown office as a storage room during [regulatory] examinations".

Following a regulatory rebuff in 1993, the bank had assured regulators that traders would no longer report to Iguchi while he occupied his role as head of the securities custody department. In fact, the branch continued to operate without a proper division of responsibilities. Furthermore, during the 1995 investigation, Iguchi revealed that between 1984 and 1987, other Daiwa traders had suffered major losses; these had apparently been concealed from regulators by shifting the losses to Daiwa's overseas affiliates (FDIC, 1995).

Confession and cover-up

In Iguchi's confessional letters to Daiwa in mid-summer 1999 (he sent a stream of letters and notes to the bank after that initial July 13 letter) the rogue custody officer suggested that his superiors keep the losses secret until "appropriate measures" could be taken to stabilise the situation. It was a suggestion that was taken up. In the period after July 13 and before about September 18, when Daiwa belatedly advised the Federal Reserve Board of the loss, certain of Daiwa's managers connived with Iguchi to prevent the losses being discovered, despite a legal requirement to report misdoings immediately to the US regulators.

For example, during September 1995, Iguchi was told to pretend to be on holiday so that a scheduled audit would have to be postponed; he was in fact in the New York apartment of a Daiwa manager helping to reconstruct the trading history of his department. Daiwa's managers seem to have been hoping to transfer the loss to Japan, where it could have been dealt with outside the scrutiny of the US regulators and markets.

After Daiwa told regulators about the loss on September 18, Iguchi was taken to a motel and questioned directly by the US Federal Bureau of Investigation. He told FBI agents about what had gone on in the months following his initial confession to Daiwa, and the bank was shocked to find itself facing a 24-count indictment for conspiracy, fraud, bank exam obstruction, records falsification and failure to disclose federal crimes.

Daiwa argued, rightly, that not a single customer of the bank had lost any money. At the time of the incident, Daiwa was one of Japan's top 10 banks and one of the top 20 banks in the world in terms of asset size. Like most other Japanese, and some European, banks, it had massive "hidden profits" on its balance sheet that were not accounted for due to the legitimate historical accounting method that it employed. That gave Daiwa's management considerable freedom of action if unexpected problems arose. One of the bank's crisis management actions after Iguchi confessed was to pump back into the defrauded account securities equivalent to those that their New York head of custody had sold off.

But the US regulators were deeply unhappy at the attempted cover-up, and at the way Daiwa had seemed to ignore regulatory warnings over a number of years. They were also unhappy that at least one senior member of Japan's ministry of finance knew about the Daiwa scandal in early August and had not informed his US regulatory counterpart.

This pushed the Daiwa scandal onto the international political stage and led to a telephone conversation in which Japan's finance minister, Masayoshi Takemura, was obliged to make apologetic noises to US Treasury secretary Robert Rubin for his staff's failure to pass on the information. (The call was made only after Takemura had annoyed US officials by denying at an earlier press conference that his ministry had failed in its duties; his aides later denied that any formal apology had been made to Rubin.)

At a time when the Japanese banking system was already showing signs of strain from the slowing Japanese economy and deteriorating asset quality, many international regulators took the Daiwa scandal and its aftermath as a sign of the continuing lack of openness in Japanese banks and the Japanese financial system.

Meanwhile, Daiwa faced more immediate problems. In November 1995, the Federal Reserve ordered it to end all of its US operations

Timeline of events

July 13, 1995 Toshihide Iguchi of the New York branch of Daiwa Bank confesses to superiors that he has lost $1.1 billion over 11 years while trading US Treasury bonds.

August 8 Japan's ministry of finance is informed about the scandal by Daiwa.

September 15-18 Daiwa belatedly reports the loss to the US Federal Reserve Board, warning that immediate disclosure of a loss of that magnitude might threat the financial viability of the bank.

September 23 Iguchi interviewed at a motel by FBI agents who later arrest him.

September 26 Iguchi fired by Daiwa and the extent of the bank's loss made public.

October 2 US authorities order Daiwa to put an end to most of its trading in the US, having already shocked the bank by indicting it on serious charges.

December 1996 Iguchi sentenced to four years in prison and a $2.6 million penalty (fine and restitution payments).

End January 1996 Daiwa agrees to sell most of its assets and offices in the US.

February 1996 Daiwa agrees to pay a $340 million fine to avoid further legal battles over its institutional role in the Iguchi affair – one of the largest ever fines in a criminal case in the US.

20 September 2000 Osaka court says some current and some former board members and executives from the bank must pay the bank $775 million as restitution to shareholders. The board members and executives immediately appeal against the decision.

within 90 days. By January 1996, Daiwa had agreed to sell most of its assets in the US, totalling some $3.3 billion, to Sumitomo Bank and to sell off 15 US offices. (Indeed, for some time after the debacle, Daiwa was rumoured to be on the verge of merging with Sumitomo.)

In February 1996, Daiwa agreed to pay a $340 million fine – a record amount for a criminal case in the US – as a way of laying to rest the charges that US authorities had brought against it. All in all, it endured some of the stiffest punishments ever meted out to a foreign bank operating in the US.

By this point, senior figures at the bank had resigned or indicated they would take early retirement. Top management said it would cut its own pay for six months and forgo bonuses as a sign of contrition.

Iguchi's nightmare was now dissipating. In October 1995, he had reached an agreement with his US prosecutors and admitted misapplication of bank funds, false entries in bankbooks and records, money laundering and conspiracy. Iguchi told the judge at early hearings that by the time he confessed: "After 11 years of fruitless efforts to recover losses, my life was simply filled with guilt, fear and deception."

He said he sent the confession letter because he couldn't see that anyone other than himself was likely to bring the situation to an end. In December 1996, he was sentenced in New York to four years in prison and a $2.6 million penalty that he had little chance of paying. The cover-up also led to one of Iguchi's managers being sent to prison for a number of months and fined a few thousand dollars.

The Aftermath

As this account makes clear, Daiwa's 1995 debacle resulted in huge losses; a criminal charge against the bank; Daiwa's forced exit from US markets; general reputational damage to Japanese banks and regulators; senior resignations at Daiwa; and a diplomatic spat between the US and Japan.

In the medium term, the scandal led indirectly to Standard & Poor's downgrading Daiwa's credit rating from A– to BBB, and to Japan's ministry of finance imposing certain restrictions on the bank's activities for a year or so. It also temporarily threatened the credibility of its profitable trust business.

In the longer term, the scandal obliged Daiwa's management to refocus the bank on its traditional retail and trust banking units. By 1998, this refocus – and the general malaise in Japanese banking – led Daiwa to announce that it would close down many of its international offices to concentrate on its role as a super-regional bank in Southeast Asia, with a specific focus on the Osaka region.

Bank executives at the time of the scandal in 1995 found that it dogged them into the new millennium. On 20 September 2000, the BBC reported that a Japanese court had ordered 11 current and former board members and executives from the bank to pay the bank $775 million in damages, much of it awarded against the president of Daiwa's New York branch during the Iguchi period.

Judge Mitsuhiro Ikeda made it clear that the award was compensation to the bank's shareholders for the fact that "the risk management mechanism at the [New York] branch was effectively not functioning", as well as for management's failure to report the incident promptly, and failures in oversight.

Some commentators were surprised by the size of the record-breaking award, however, and the executives immediately appealed against the decision and filed pleas with the court to suspend any seizure of their assets.

Whether or not the award stands, many commentators at the time said that it marked a broader change in attitudes about executive and board responsibility. In Japan, as in most developed economies, it is becoming more and more likely that senior management in charge of a bank or corporation at the time of a disaster will be held personally accountable. ■

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